Australian Accounting Standard **AAS 5**
(9/95)

Materiality

Prepared by the
Public Sector Accounting Standards Board of the
Australian Accounting Research Foundation and by the
Australian Accounting Standards Board

Issued by the
Australian Accounting Research Foundation on behalf of the **Australian Society of Certified Practising Accountants** and **The Institute of Chartered Accountants in Australia**

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Australian Accounting Research Foundation
211 Hawthorn Road
Caulfield Victoria 3162
AUSTRALIA

Phone (03) 9523 8111

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ISSN 1034-3717

AAS 5

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For words printed in *italics* see definitions in section 5.(Defined words appear in italics the first time they appear in a section.) Standards are printed in **bold** type and commentary in light type.

MAIN FEATURES OF THE STANDARD

The Standard:

(a) defines materiality

(b) explains the role of materiality in making judgements in the preparation and presentation of the financial reports

(c) requires the standards specified in other Australian Accounting Standards to be applied where their effect is material.

The major revisions to the superseded Australian Accounting Standard AAS 5 "Materiality in Financial Statements", as issued in November 1986, are:

(a) inclusion of a specific requirement to apply th e Standards specified in other Australian Accounting Standards when material

(b) inclusion of additional guidance on determining whether an item or an aggregate of items is material.

AUSTRALIAN ACCOUNTING STANDARD

AAS 5 "MATERIALITY"

1 Application

1.1 This Standard applies to *general purpose financial reports* of:

(a) each private sector *reporting entity*; and

(b) each public sector reporting entity;

to which Accounting Standards operative under the Corporations Law do not apply.

1.2 This Standard applies to financial reports that are held out to be general purpose financial reports by an *entity* which is not a reporting entity.

1.2.1 Accounting Standards operative under the Corporations Law apply to companies and to other entities required by legislation, ministerial directive or other government authority to apply such Standards. Reporting entities which are not required to apply Accounting Standards operative under the Corporations Law are required to apply this Standard.

2 Operative Date

2.1 This Standard applies to reporting periods ending on or after 30 June 1996.

2.2 This Standard may be applied by an *entity* specified in section 1 to reporting periods ending before 30 June 1996.

2.2.1 AAS 5 "Materiality in Financial Statements", as issued in November 1986, continues to apply for reporting periods that end before 30 June 1996. However, where an entity elects to apply this Standard early in accordance with paragraph 2.2 it will not also be obliged to comply with AAS 5, as issued in November 1986, for the reporting periods to which the election applies.

2.3 When operative, this Standard supersedes Australian Accounting Standard AAS 5 as issued in November 1986.

3 Purpose of Standard

3.1 The purpose of this Standard is to:

(a) define *materiality*; and

(b) explain the role of materiality in making judgements in the preparation and presentation of the financial reports; and

(c) require the standards specified in other Australian Accounting Standards to be applied where information resulting from their application is material.

3.1.1 Financial reporting encompasses the provision of financial statements and related financial and other information. Financial reports are the principal means of communicating financial information about a *reporting entity* to users. In order to meet the objective of *general purpose financial reporting* specified in Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting", information provided in the financial report needs to be useful to users for making and evaluating decisions about the allocation of scarce resources and must possess the qualitative characteristics specified in Statement of Accounting Concepts SAC 3 "Qualitative Characteristics of Financial Information".

3.1.2 General purpose financial reporting involves making decisions about the information to be included in general purpose financial reports and how it is to be presented. In making these judgements, considerations of materiality play an essential part. This is because the inclusion of information which is not material or the exclusion of information which is material may impair the usefulness of the information provided to users.

4 Application of Materiality

4.1 The standards specified in other Australian Accounting Standards apply to the financial report where information resulting from their application is *material*. Information is material if its omission, misstatement or non-disclosure has the potential to adversely affect:

(a) decisions about the allocation of scarce resources made by users of the financial report; or

(b) the discharge of accountability by the management or governing body of the *entity*.

4.1.1 The notion of materiality influences whether an item or an aggregate of items is required to be *recognised*, measured or disclosed in accordance with the requirements of an Australian Accounting Standard. Where an item or an aggregate of items is not material, application of the materiality notion does not mean that those items would not be recognised, measured or disclosed, but rather that the entity would not be required to recognise, measure or disclose those items in accordance with the requirements of an Australian Accounting Standard.

4.1.2 In addition to guiding the application of the recognition, measurement and disclosure requirements, the notion of materiality guides the margin of error that is acceptable in the amount attributed to an item or an aggregate of items and the degree of precision required in estimating the amount of an item or an aggregate of items.

4.1.3 In deciding whether an item or an aggregate of items is material, the nature and amount of the items usually need to be evaluated together. In particular circumstances, either the nature or the amount of an item or an aggregate of items could be the determining factor. For example:

(a) in the context of error corrections or adjustments for events occurring after balance date, materiality based on amount alone is sufficient to require a correction or an adjustment to be made; and

(b) it may be necessary to treat as material an item or an aggregate of items which would not be judged to be material on the basis of the amount involved, because of their nature. This may apply where:

(i) a change in accounting method has taken place which is expected to affect materially the results of subsequent reporting periods, even though the effect in the current reporting period is negligible; or

(ii) transactions occur between an entity and parties who have a fiduciary responsibility in relation to that entity, such as those transactions outlined in Australian Accounting Standard AAS 22 "Related Party Disclosures"; or

(iii) restrictions on the powers and operations of the entity affect the risks and uncertainties relating to an item, for example, legal restrictions imposed by governments on assets held in foreign countries; or

(iv) an entity expands its operations into a new segment which affects the assessment of the risks and opportunities facing the entity; or

(v) a change in circumstances puts the entity in danger of breaching a financial covenant.

4.1.4 In determining whether the amount of an item or an aggregate of items is material:

(a) the amount of an item or an aggregate of items relating to the statement of financial position is to be compared with the more appropriate of:

(i) the recorded amount of equity; and

(ii) the appropriate asset or liability class total; or

(b) the amount of an ite m or an aggregate of items (including extraordinary items) relating to the profit and loss or other operating statement is to be compared with the more appropriate of the:

(i) operating result/profit or loss and the appropriate revenue or expense amount for the current reporting period; and

(ii) average operating result/profit or loss and the average of the appropriate revenue or expense amounts for a number of reporting periods (including the current reporting period); or

(c) the amount of an item or an aggregate of items relating to the statement of cash flows is to be compared with the more appropriate of the:

(i) net cash provided by or used in the operating, investing, financing or other activities as appropriate, for the current reporting period; and

(ii) average net cash provided by or used in the operating, investing, financing or other activities as appropriate, for a number of reporting periods (including the current reporting period).

4.1.5 As not-for-profit entities are primarily concerned with the achievement of objectives other than the generation of profit, such as service delivery, it may not be appropriate to assess materiality for profit and loss or other operating statement items by reference to operating result/profit or loss or average operating result/profit or loss in the manner outlined in paragraph 4.1.4(b). In these cases, the guidance set out in paragraphs 4.1.8 to 4.1.10 is more appropriate to consider. Not-for-profit entities include those entities whose primary objectives do not include the generation of profit (or a surplus) for distribution to members.

4.1.6 Quantitative thresholds used as guidance for determining the materiality of the amount of an item or an aggregate of items must, of necessity, be drawn at arbitrary levels. Materiality is a matter of professional judgement influenced by the characteristics of the entity and the perceptions as to who are, or are likely to be, the users of the financial report, and their information needs. Materiality judgements can only be properly made by those who have the facts. In this context, the following quantitative thresholds may be used as guidance in considering the materiality of the amount of items included in the comparisons referred to in paragraphs 4.1.4(a), (b) and (c) of this Standard:

(a) an amount which is equal to or greater than 10 per cent of the appropriate base amount may be presumed to be material unless there is evidence or convincing argument to the contrary; and

(b) an amount which is e qual to or less than 5 per cent of the appropriate base amount may be presumed not to be material unless there is evidence, or convincing argument, to the contrary.

4.1.7 In relation to items or an aggregate of items in the profit and loss or other operating statement, an amount as referred to in paragraphs 4.1.6(a) or (b) is to be an amount after allowing for any income tax effect where the base amount has itself been determined after allowing for any income tax effect.

4.1.8 In practice materiality judgements are typically made on the basis described in paragraph 4.1.4. However, further indications of materiality may be evident from making assessments of the items in an absolute and a relative context. This may necessitate disclosure of information in the financial report about items which are not considered to be material in amount in accordance with paragraph 4.1.4.

4.1.9 In absolute terms, consideration is to be given to the financial report as a whole. In particular, consideration is to be given to factors which may indicate deviations from normal activities such as the reversal of a trend, turning a profit into a loss or creating or eliminating the margin of solvency in a statement of financial position. For example, where the entity's financial position has deteriorated, and the entity has revalued its assets upwards, information regarding the revaluation of those assets would be likely to be material, and thus the accounting and disclosure requirements specified in Australian Accounting Standard AAS 10 "Accounting for the Revaluation of Non-Current Assets" would apply, even though the revaluation amount may not be material by comparison with the recorded amount of equity or the appropriate asset class total.

4.1.10 In relative terms, items are to be compared to any directly related items. The amount of an item may not be material when judged on the basis described in paragraph 4.1.4, but its size in relation to a related item may indicate that information about it is material. For example, the amount of interest revenue would be compared with the amount of the relevant loans. Such a comparison may indicate that information about the interest is material because its amount is much lower (or higher) than expected, having regard to the loan balance and applicable interest rates.

5 Definitions

5.1 In this Standard:

economic entity* means a group of *entities* comprising the *parent entity* and each of its *subsidiaries

***entity* means any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives**

***general purpose financial report* means a financial report intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs**

***materiality* means, in relation to information, that information which if omitted, misstated or not disclosed has the**

potential to adversely affect decisions about the allocation of scarce

resources made by users of the financial report or the discharge of accountability by the management or governing body of the entity

***parent entity* means an entity which controls another entity**

***recognised* means reported on, or incorporated in amounts reported on, the face of the profit and loss or other operating statement or of the statement of financial position (whether or not further disclosure of the item is made in notes thereto)**

***reporting entity* means an entity (including an *economic entity*) in respect of which it is reasonable to expect the existence of users dependent on *general purpose financial reports* for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources**

***subsidiary* means an entity which is controlled by a parent entity.**

5.1.1 See Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements" for guidance as to the definitions of assets, liabilities, equity, revenues and expenses.

CONFORMITY WITH INTERNATIONAL AND NEW ZEALAND ACCOUNTING STANDARDS

Conformity with International Accounting Standards

Standards dealing with materiality have not been issued by the International Accounting Standards Committee (IASC). However, some guidance is provided on materiality in the "Framework for the Preparation and Presentation of Financial Statements" issued by the IASC. As at the date of issue of this Standard, compliance with this Standard will ensure conformity with the International Framework to the extent that it addresses materiality.

Conformity with New Zealand Accounting Standards

As at the date of issue of this Standard, compliance with this Standard will ensure conformity with Statement of Standard Accounting Practice SSAP-6 "Materiality in Financial Statements".

DEVELOPMENT OF THE STANDARD

This section does not form part of the Standard or commentary. It is a summary of the development of the Standard and the Public Sector Accounting Standards Board's and the Australian Accounting Standards Board's consideration of the key issues dealt with in the Standard.

1 The issue of the Standard follows consideration of the responses received on Exposure Draft ED 60 "Accounting Policies", which was prepared by the Public Sector Accounting Standards Board of the Australian Accounting Research Foundation and by the Australian Accounting Standards Board and released in February 1994. ED 60 proposed that authoritative guidance on materiality would be located within the Accounting Policies Standards.

Noteworthy Changes to ED 60

2 One of the main changes to ED 60 is that guidance on materiality has been included in the Standard rather than within the Accounting Policies Standard. The Boards decided that it is appropriate to define and explain materiality in a separate Standard because the notion of materiality must be considered when applying the requirements in each Australian Accounting Standard. This approach is expected to overcome the confusion concerning materiality which was identified in the responses to ED 60.

3 The effect of issuing the Standard is that the requirements of each other Standard need only be applied where the resultant financial information is material, unless the other Standard specifically states otherwise.

4 The Boards concurred with respondents' views that assessments of materiality should take into account the cumulative effect of items and relationships between items. Discussion has been included in the Standard to explain this.

5 In the context of not-for-profit entities, respondents raised concerns with the guidance for determining the materiality of the amount of a profit and loss or other operating statement item by reference to the operating result/profit or loss. The Boards agree that this

approach to determining materiality is likely to be inappropriate. Commentary has been included to indicate that it may not be appropriate for not-for-profit entities to assess materiality for profit and loss or other operating statement items in the same manner as profit-seeking entities.

Principal Features of ED 60 Retained in the Standard

6 Respondents to ED 60 did not raise any major concerns with the principal features of ED 60 which have been retained in the Standard.

Operative Date

7 Less than twelve months notice between the issue date and the operative date of the Standard is provided because the Boards consider the requirements of the Standard do not differ significantly to those of the superseded Standard.